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Southern Europe: Short-Term Economic Prospects May 75 ER IM 75-9

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Intelligence Memorandum

Southern Europe: Short-Term Economic Prospects

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Southern Europe: Short-Term Economic Prospects

All six south European countries important to the NATO defense system – Cyprus, Greece, Italy, Portugal, Spain, and Turkey – have been buffeted by political and economic troubles over the past year. Their economic problems are remarkably similar, with notable exceptions in war-torn Cyprus. Faltering output, growing unemployment, rising prices, and dwindling foreign reserves are characteristic. The political impact of such difficulties varies widely among the countries. Conversely, recent political changes are threatening short-term economic progress much more in some countries than in others.

The oil crisis, domestic political uncertainties, and widespread recession abroad combined to prevent normal economic growth throughout the region last year, particularly in the final quarter. Output in Greece and Cyprus actually declined; in the other countries, increases in GNP were a little below their long-term averages of 5%-7%. The outlook for 1975 is bleaker. None of the countries except Turkey is likely to expand GNP by more than 3%; Italy faces a small decline in output.

Unemployment increased substantially in all six countries last year as the effects of domestic economic slowdown were compounded by refluxes of workers from recession-ridden north European countries. The problem will worsen in 1975, with average unemployment rates expected to range from 4% to 10%.

The countries' balance-of-payment positions deteriorated drastically in 1974. All six registered current account deficits, some very large. Higher oil bills were the main factor, but most countries also suffered a reduced growth in tourist income and workers' remittances. All the countries will incur large current account deficits in 1975 but should be able to finance them by borrowing from private and official institutions abroad and dipping into foreign reserves.

Note: Comments and queries regarding this memorandum are welcomed. They may be directed to [redacted] of the Office of Economic Research, Code 143, Extension 7402.

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Inflation raged throughout southern Europe last year, with increases in consumer prices generally in the 20% range. Soaring energy costs, large government deficits, and exorbitant wage increases all contributed to the problem. Greece has made the most progress recently on the inflation front but still faces a double-digit rate in 1975. In mid-April, the Portuguese government froze prices of staple foodstuffs and broached the issue of wage controls. Despite talk of austerity, most of the governments seem unwilling to depress demand (and raise unemployment) in order to break the wage-price spiral. For Cyprus, Italy, Spain, and Turkey, price increases threaten to reach 20%-30% in 1975.

The political and economic outlook is most ominous in ***Portugal,*** which is a member of NATO and supplies both the United States and NATO with important military facilities. The recent abortive coup played into the hands of the leftist Armed Forces Movement, enabling it to strengthen its control over the country's affairs. The political parties have now agreed to the Movement's continued dominance for a period of 3-5 years.

The Portuguese economy is suffering as a result of the economic mismanagement of the revolutionary regime, which has fostered industrial anarchy and given rise to a phenomenal rise in wages. The government nationalized banks and the insurance companies in March and a number of utilities and basic industries a month later. At the time of the latter move, Lisbon also decreed a program of land reform and warned of further nationalizations. Portugal is moving gingerly toward strengthened economic relations with the USSR.

Across the border in ***Spain,*** where the United States also has valuable bases, economic problems could complicate the eventual transfer of power from Franco to Juan Carlos. Labor unrest is on the rise as a result of worsening unemployment and inflation. Prime Minister Arias also is finding it difficult to pluralize Spanish politics by permitting political associations outside the rightist National Movement. He probably will continue a hard line on disaffection among students and workers, aggravating a potentially explosive situation.

In ***Italy,*** the bastion of NATO's southern flank, economic woes will cost the Christian Democrats votes in the June nationwide regional and local elections, probably to the benefit of the Socialists and Communists. The economy's difficulties probably will not be severe enough to precipitate a radical leftward shift; thus, another center-left government is the most likely outcome. If the Socialists strengthen their position within the government, Italy may adopt a more expansionary economic policy after midyear.

Events in the eastern Mediterranean recently have been dominated by the ***Cyprus*** tragedy. Since the Turkish invasion of Cyprus – site of important British bases -- life has been thoroughly disrupted by ***de facto*** partition of the island and displacement of a large portion of the population. In the Greek Cypriot sector, the Makarios government is trying to reorganize the truncated economy and care for thousands of refugees while attempting to maintain the tenuous unity among rival Greek Cypriot factions. The Turkish Cypriots are somewhat better off. They got most of the island's resources and have a more stable political situation because Ankara is running the sector almost like an extension of the Turkish mainland.

In ***Turkey,*** NATO's southeastern anchor, military success in Cyprus brought problems as well as an initial euphoria. The shaky Ecevit government fell only two months after the invasion, and the huge cost of the operation – possibly US $1 billion so far – has diverted resources needed at home. Economic strains are adding to the headaches of Prime Minister Demirel's National Front coalition, put together after six months of effort. Inclusion of two extreme-right parties in the government threatens further left-right polarization of politics.

Greece, which withdrew from NATO's military structure in 1974, has the brightest short-term political and economic outlook of the six. The political situation appears stable, with popular Prime Minister Karamanlis in firm control of a democratic government. A shakeup of the armed forces to weed out disloyal officers has raised passions but ultimately should strengthen the principle of government by elected civilians. Renewed confidence in the government and a reflationary economic policy are attracting foreign investment and helping the economy recover from the 1974 recession.

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CYPRUS: ECONOMIC RECOVERY NOT IN SIGHT

Eight months after the Turks invaded Cyprus, the once-prosperous island is still reeling from the war and the resulting unbalanced disposition of resources. Both the Greek and Turkish sectors face at least another year of economic dislocation, which will further destabilize the political situation.

On the Eve of the Invasion

The Cypriot economy was already under stress before the war. Drought had reduced agricultural output by 20% in 1973 and had helped cut economic growth to only 2%, compared with the hefty 7% average of the previous 10 years. The grain shortage had aggravated inflation and stimulated imports, causing a rare balance-of-payments deficit. Economic strains had worsened in early 1974 under the impact of sharp price increases for oil and other commodities. By midyear, inflation was running at 12% and unemployment was double the usual low level.

Effects of the War

The invasion of July-August 1974 drastically worsened the situation. Although damage to structures was small, half the livestock and much standing timber were destroyed. More than 200,000 persons, out of a population of 660,000, were displaced. The Greek population lost half of its agricultural land, most of its tourist facilities, some iron and copper processing plants, and several large ports. In effect, the bulk of the island's resources was transferred to the Turkish Cypriots.

Situation in the Greek Sector

At yearend, the truncated Greek Cypriot economy still was staggering from the effects of the invasion. Production in the petroleum refining, brewing, bottling, and clothing plants still in Greek hands was down severely from midyear levels. Inflation had accelerated to a 15% annual rate, earnings from tourism and the British bases at Dhekelia and Akrotiri had tumbled, and the unemployment rate remained at roughly 30%. Foreign exchange reserves continued at the island's prewar level only because the contraction and disruption of the economy caused imports to fall even more than exports.

Starting last October, the Greek Cypriot government took its first steps toward rebuilding the economy, including

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- a 30% deduction from wages and profits to support the refugee relief fund established soon after the invasion;

- temporary restrictions on the dismissal of workers in the private sector;

- earmarking of $4 million in government funds to create jobs; and

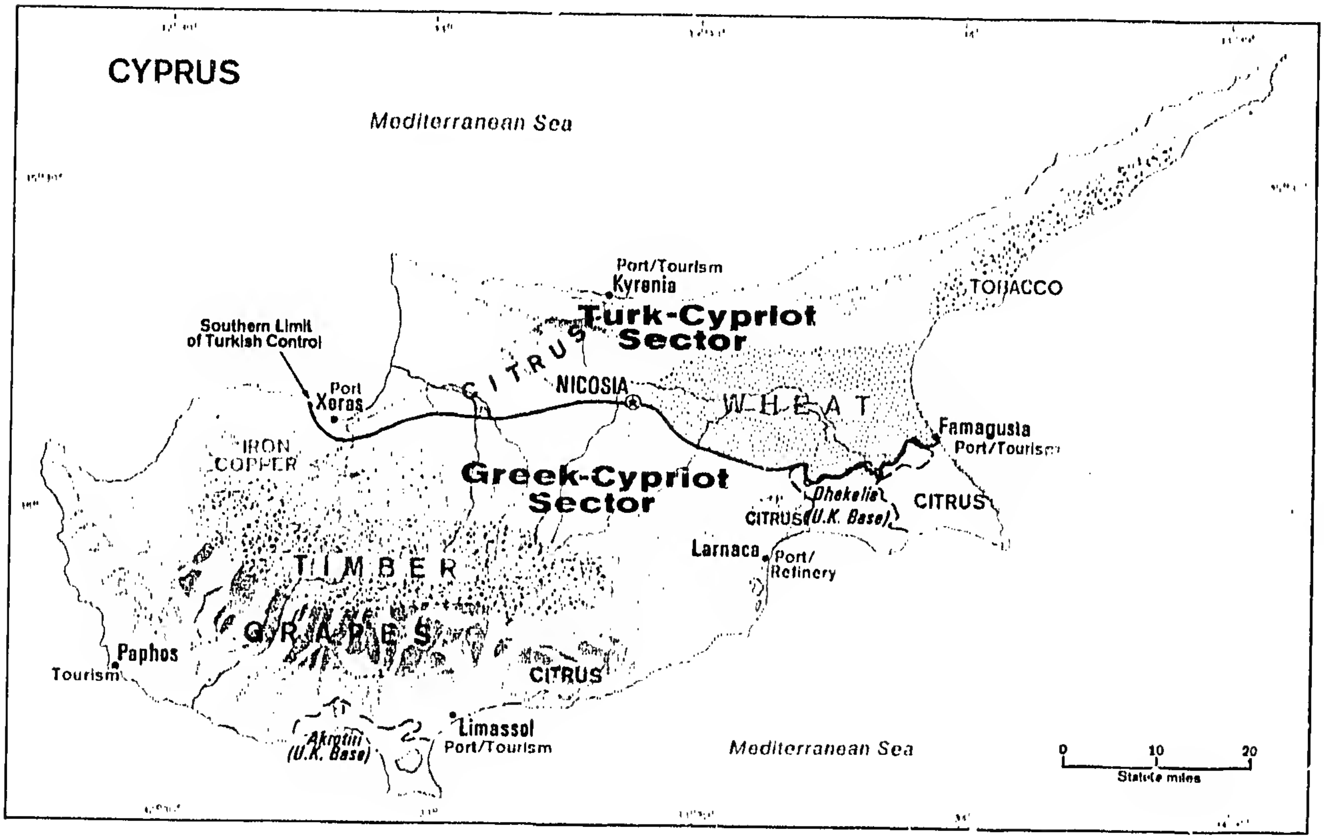
- prompt completion of the deepwater port at Limassol, the building of an airport at Larnaca, and the construction of several new roads.

The short-term outlook is grim because the government is constrained by inadequate revenues and an unwillingness to accept the reality of partition. Although reconstruction work, government financial aid for business, and emigration should reduce unemployment by two-thirds this year, at least 20,000 people will remain on the government dole. The sector's budget could go into the red by $250 million in 1975 since reconstruction and relief needs are substantial and Athens is providing little assistance. The financing of such a deficit – twice the deficit of the whole island last year -- practically guarantees that inflation will continue in the two-digit range.

To meet essential needs of consumers and enterprises, the Makarios government will have to dip into Cypriot foriegn reserves, which remain under its control. Import volume will increase as reconstruction proceeds and employment expands. Export volume will remain low because production of citrus fruits – the main export -- has passed into Turkish hands. The area probably will suffer deterioration in terms of trade; prices are generally weakening for its exports of foodstuffs and raw materials. With tourist earnings wiped out and revenues from the British bases down (most dependents have departed), foreign reserves could fall $135 million, or 50%, this year.

Situation in the Turkish Sector

The new Turkish Cypriot state is experiencing economic paralysis despite considerable aid from Turkey. Ankara, which dominates the interim administration of Rauf Denktash, has begun to lay down the institutional prerequisites for growth by developing a five-year plan, making the Turkish lira the common currency, and installing the Turkish Agricultural Bank as the Sector's central bank. Turkish military and civilian engineers already have restored basic services.



The labor shortage nonetheless has kept most industrial firms from resuming operations. Commercial activity has slipped badly because many former Greek Cypriot businesses have been given to untrained Turkish Cypriot migrants from the south. While the citrus crop has been gathered and marketed, other agricultural activity continues at a depressed level, with many farms still unoccupied.

Little economic expansion is likely this year, because the Turkish Cypriots lack the numbers, skills, and money needed to marshal their resources. Economic problems at home have induced Ankara to reduce its assistance and to offer loans instead of grants. Efforts to attract private Turkish investment are having scant success. Unless Ankara pours in more money and persuades more mainland residents to migrate, recovery promises to be slow. (Unclassified)■

GREECE MOVES SLOWLY TOWARD REFLATION

The government of Constantine Karamanlis, installed last July and confirmed in office by the November election, is cautiously trying to get the economy moving again. The military government in its last year had slowed inflation and contained the trade deficit at the cost of declining output. Economic activity has picked up under the new regime; further progress seems likely in 1975.

Reviving Growth

Both industrial production and GNP declined in 1974 by about 2%, after six consecutive years of rapid growth. Although still hamstrung by inflation and trade problems, the economy began to recover after midyear. By October, industrial production had recouped three-fifths of the 16% drop from the February 1974 peak.

Tight fiscal and monetary policies adopted in late 1973 started the slowdown; mobilization for the Cyprus crisis in July 1974 carried it to its nadir. The economy was further depressed last year by a $380 million jump in net oil imports, to $720 million. Tourism -- a major industry -- was hit hard by the worldwide economic slowdown and a spurt of anti-Americanism following Turkey's invasion of Cyprus.

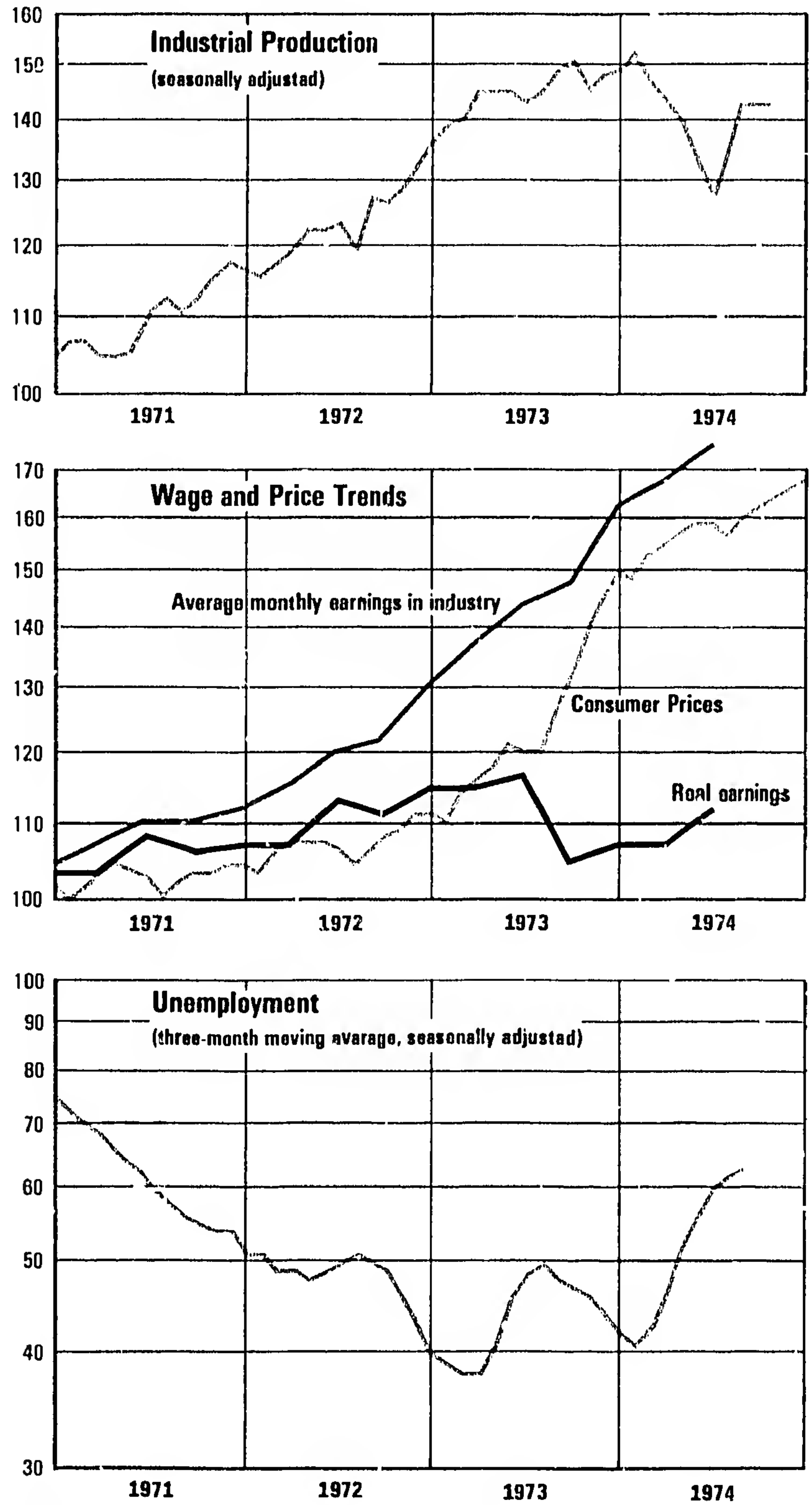
The Karamanlis government has continued the moderately expansionary line initiated by the military government just before its ouster. It quickly abolished a special tax on construction and has now eased credit restraints. The 1975 budget calls for spending to rise by one-third, an increase that almost certainly will exceed the rise in tax collections. To spur consumption, the government is providing tax concessions to low-income groups.

Fear of rekindling inflation will act as a brake on government stimulative efforts. The austerity program held the rise in consumer prices to 14% in 1974 following the 30% jump of 1973. Although inflation has lessened, strong expansionary measures could send prices soaring again.

GNP should post a small gain in 1975, perhaps exceeding the 1973 level by a percentage point or so. Recent announcements of major investment projects suggest that the new regime has won the confidence of domestic and foreign businessmen. Unemployment nevertheless is likely to worsen because of the scarcity of jobs for migrant workers in recession-plagued Western Europe.

GREECE: ECONOMIC INDICATORS

Index: 1970 annual average = 100



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Balance-of-Payments Constraints

Balance-of-payments problems will keep Athens from moving vigorously to spur growth. The trade deficit amounted to $2.4 billion in 1974 – about the same as in 1973 – even though import volume fell, export volume rose substantially, and export prices increased nearly as much as import prices. This somber arithmetic reflects the fact that export earnings in 1973 were only one-third as large as import expenditures.

Financing problems would have been more severe if an increase in receipts from transport services had not almost offset the decline in tourist earnings and workers' remittances. An increase in receipts of long-term capital – mostly loans from Bonn, the IMF oil facility, and a consortium of private banks – merely compensated for the drying up of short-term capital inflows. Athens consequently drew down foreign reserves by about $110 million.

To improve the trade balance in 1975, the government intends to expand its export incentive program and maintain import restraints. Athens will rely on quantitative controls on non-oil items and heavy taxes on petroleum products. Tourism will remain depressed by high air fares, Greek-Turkish tension, and the anti-American atmosphere. Earnings from shipping services will rise little, at best.

Greece: Balance of Payments

Million US $

	1972	1973	1974 Estimated
Exports	836	1,230	1,774
Imports, f.o.b.	2,197	3,642	4,194
Trade balance	-1,361	-2,412	-2,420
Tourism	297	402	306
Transportation	358	474	663
Remittances	572	732	624
Other invisibles	-270	-384	-413
Current account balance	-404	-1,188	-1,240
Long-term capital	477	688	
Basic balance	73	-500	1,130
Other capital	263	405	
Payments balance	336	-95	-110

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In 1975, the current account deficit again will approximate $1.2 billion, forcing continued heavy borrowing abroad. Prospective lenders include Paris, the EC, and several OPEC countries. Athens will try to protect foreign reserves, which now hover about the $900 million mark. (Confidential)■

ITALY: KEEPING A STEP AHEAD OF TROUBLE

With output down, unemployment rising, and inflation maintaining a torrid pace, the Christian Democratic Party of Prime Minister Aldo Moro probably will suffer further setbacks in the regional and local elections this June. The major bright spot -- a sharp drop in the current account deficit – is not apt to impress the voters. Workers increasingly are expressing discontent through strikes for more generous fringe benefits, pensions, and unemployment compensation. Another center-left coalition probably will be put together after the elections, following lengthy negotiations.

Balance Sheet for 1974

In 1974, Italy once again muddled through, escaping the economic and political disaster widely predicted in the Western press. After tortuous compromises, the coalition government came up with an austerity program in July that greatly improved the trade account. The quadrupling of oil prices caused a $2.1 billion deficit in the first quarter; the fourth quarter deficit had narrowed to $1.3 billion. More important, the austerity measures enabled Italy to scrape together $6 billion in credits from foreign official sources. This was enough, along with some private borrowing, to avoid dissipation of reserves despite the $8 billion current account deficit.

The credit squeeze and tax hikes, principal features of the austerity program, led to a precipitous drop in industrial output in the second half. While other sectors were less seriously affected, GNP began to slide after midyear. As a result, growth for the year was held to 3.6% – still one of the highest rates in Western Europe – compared with a 5% long-term average. The number of workers on short hours or without jobs rose in the second half, adding to already substantial labor unrest and straining the union-government truce arranged in early 1973. In spite of weakening demand and slower growth in wholesale prices, inflation of consumer prices accelerated to a 28% annual rate in the second half because of sizable increases in wages, indirect taxes, and prices of petroleum products.

Dispiriting Growth Prospects

Italy probably will be the only country among the Big Six to suffer a drop in output in 1975. We anticipate a 1% decline in real GNP because Italy's shaky credit rating will encourage Rome to move very cautiously toward reflation. Even the Communist opposition is advocating fiscal moderation. The Socialists, likely to gain in the June elections, may demand economic stimulation as the price of their continued participation in the government. Measures taken after midyear probably would have little effect on economic growth in 1975.

In recent months, the government has acted more to check the decline in output than to stimulate an upswing. Preferential central bank rediscounting for banks that reduce interest rates and the removal of the import deposit scheme last month should help hold the drop in fixed investment in 1975 to about 5%. Recent increases in appropriations for public construction, subsidies to agriculture and exports, and worker income supplements do not make the 1975 budget much more expansionary than originally planned. The added spending is supposed to be covered by increases in postal rates and by tax receipts beyond the amount initially forecast. As a result of the tax reform implemented at the start of 1974, which featured income tax withholding and better enforcement, collections have improved considerably.

Ministering to Labor

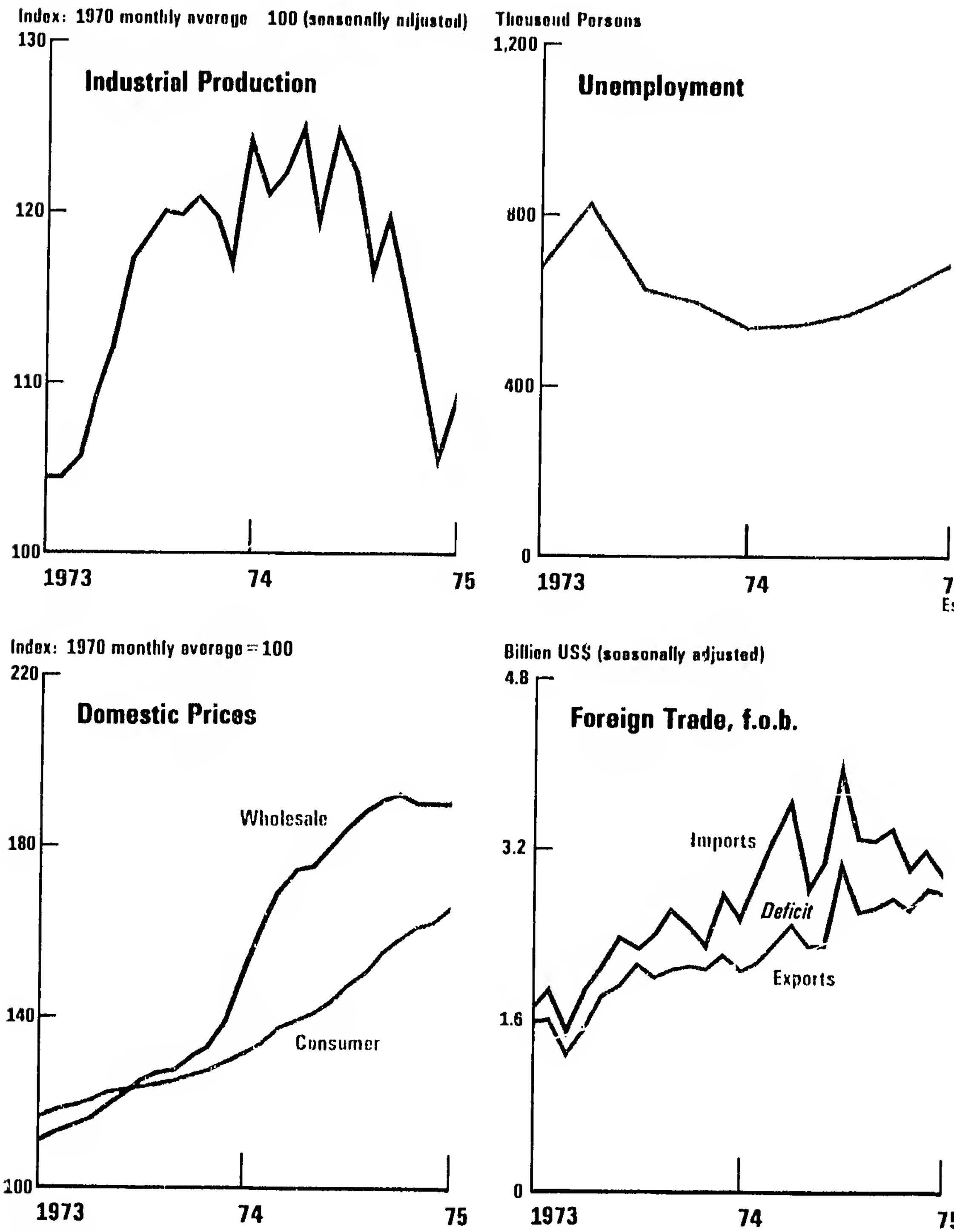
Although displeased with the government's hesitant reaction to the recession, workers probably will fare better than business this year. Union grumblings already have induced the national federation of industries and the government to greatly improve cost-of-living adjustments, family allowances, and income maintenance payments. Renegotiation this coming autumn of triennial labor contracts affecting half the industrial labor force is sure to give an added push to wages.

Concessions to labor will force up industrial costs and keep inflation boiling in 1975. We anticipate a 20% rise in consumer prices, about the same as in 1974. Even Britain, which has equally contentious labor relations, will probably not do that badly.

Wanted: $6 Billion in Foreign Capital

Barring a protracted political crisis, particularly one that led to increased Communist influence in the government, Italy should be able to finance another

ITALY: Economic Indicators



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large current account deficit this year. We expect a deficit of $6 billion, down $2 billion from 1974. Lower international commodity prices should improve Italy's terms of trade, and the recession probably will cause a slight decline in import volume. We assume that the lira will be allowed to depreciate enough to keep exports competitive despite the lofty inflation rate.

Political turmoil could upset an already shaky financial situation by

- drying up credit from private and official sources abroad,
- provoking a massive flight of domestic capital, and
- cutting off the repatriation of capital, which began in the second half of 1974 because of Italy's credit restrictions and high interest rates.

In any event, prospects of obtaining large loans directly from OPEC states are poor. President Leone's credit-seeking trip to Saudi Arabia in March was a disaster, and negotiations with Iran appear to be hopelessly tangled. Financing of the current account deficit thus will require large receipts from such petrodollar recycling mechanisms as the IMF facility and the prospective EC and OECD facilities. If such assistance is not forthcoming – or if a shift to the left scares off capital – Rome will have to curb imports and dip into its $3 billion foreign exchange reserves. (Confidential No Foreign Dissem)■

PORTUGAL: ECONOMIC PROBLEMS, UNCERTAIN SOLUTIONS

Political turmoil has been the single most important factor affecting Portuguese economic developments since a military-led coup ended 50 years of authoritarian rule in April 1974. Efforts to grapple with economic problems will be ineffectual until the political direction in Lisbon steadies.

Recent Developments

Production data are sparse, a reflection of the new government's inability to cope with administrative detail amid continuing political upheaval. As best we can determine, industrial production recovered incompletely from the estimated 35% plunge in the six weeks following the coup. Strikes have subsided since last summer, partly because workers have been pacified by huge wage increases. At the same time, tourism and other important activities remain depressed.

Portugal: Balance of Payments

Million US $

	1971	1972	1973	1974 Estimated
Exports	955	1,353	1,927	2,470
Imports (f.o.b.)	1,584	1,947	2,642	4,070
Trade balance	-629	-594	-721	-1,600
Tourism	212	261	320	300
Other services	-73	-56	-157	-100
Transfers	664	873	1,097	1,000
Current account balance	174	484	539	-400
Long-term capital, private	76	62	-37	
Long-term capital, public	-12	-191	-104	
Short-term capital	-6	-137	....	-100
Errors and omissions	35	60	-56	
Surplus or deficit	267	278	342	-500

Unemployment is now the most critical economic problem. The growing body of jobless workers, mostly unskilled and uneducated, constitutes a particularly volatile element in the political tinderbox. At least 200,000 people – 7% of the labor force – are idle. The sharp increase in unemployment is the result of a combination of factors: industrial slowdown and political turmoil at home, worldwide recession, return of soldiers and settlers from the African provinces, and the diminishing ability of North European countries to absorb surplus Portuguese laborers.

Inflation continues to be worse than in most Western countries; consumer prices went up about 25% last year despite a temporary price freeze following the coup. Wages lagged behind the price spiral until April. The drop in real wages was especially pronounced in the half year preceding the coup. This situation has changed sharply. The official wage index for the third quarter showed a 39% gain over the year-earlier level – more than offsetting the rise in prices. We estimate an even greater increase in wages in the quarter – an average of 75% in the 12 largest industries.

The trade deficit more than doubled in 1974, to an estimated $1.6 billion. The rise in oil costs accounted for half of this increase. Net food and agricultural imports jumped by $340 million because of higher consumption by low-income groups. A one-third increase in the traditional net earnings from paper, textile,

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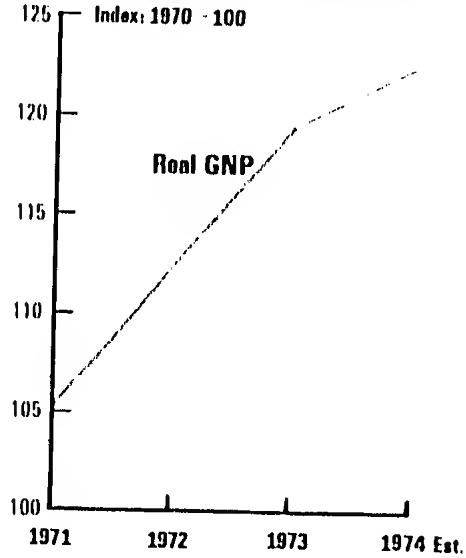
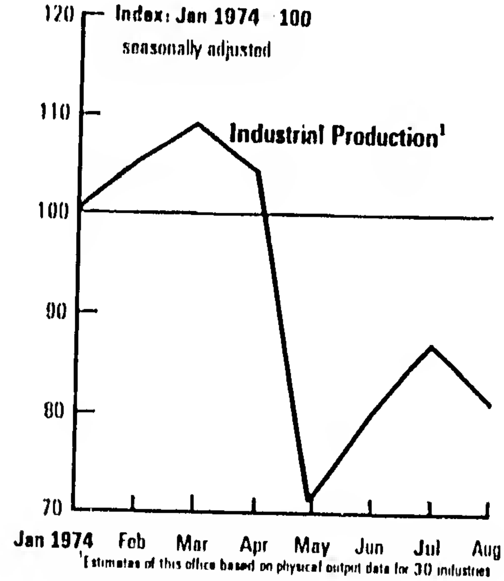
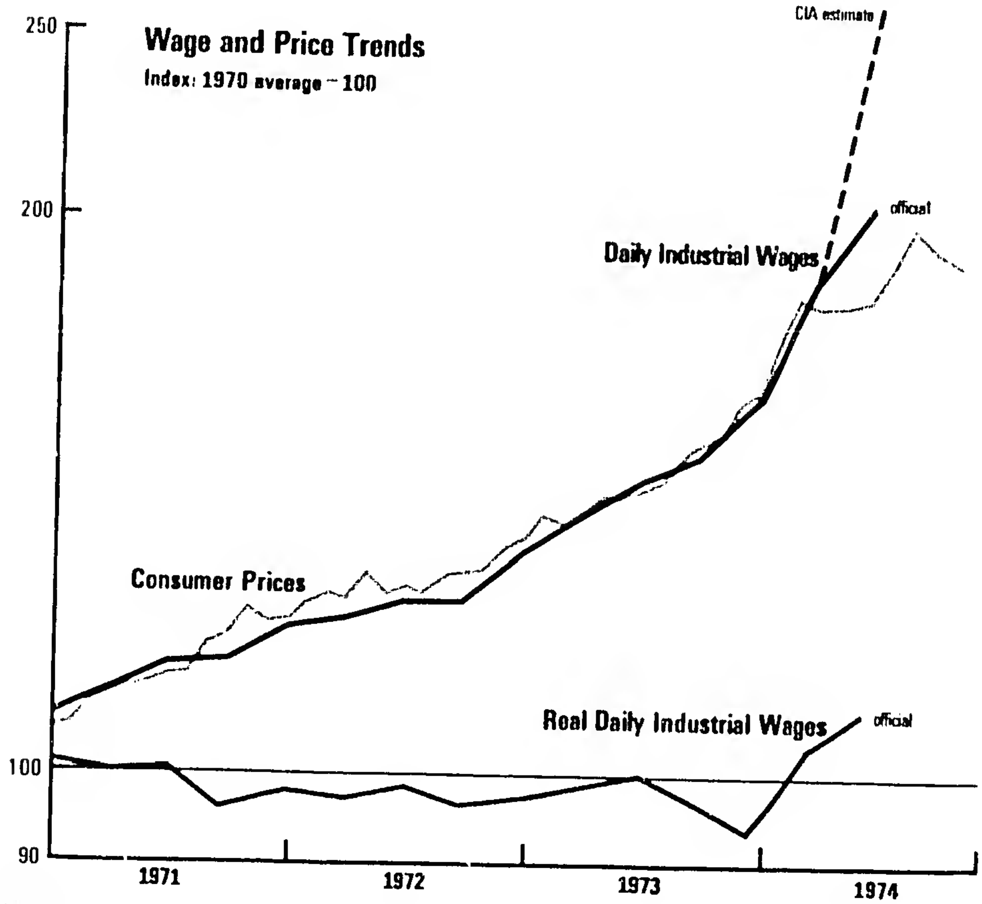
PORTUGAL: Economic Indicators

GNP and Industrial Production





[1] Estimates of this office based on physical output data for 30 industries



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and wood products, to $450 million, offset only a small part of the rise in imports. With invisible earnings also declining, the current account shifted from a $540 million surplus to a deficit of about $400 million.

Outlook

With the political Left ascendant, private enterprise has lost ground fast since the abortive Rightist coup of 11 March. Moreover, moderates have little chance to redress the situation in the constitutional assembly election scheduled for 25 April. The Left-leaning Armed Forces Movement has institutionalized itself in a Revolutionary Council that is to dominate the government for 3 to 5 years. Among the Council's first acts was nationalization of the banks and insurance companies in March, an action that went beyond the socialization program published in February. On 16 April, the Council also nationalized electric utilities, oil companies, railways, the national airline, two shipping companies, and the steel industry and began a program of agrarian reform by limiting the size of individual land holdings. At the same time, Lisbon announced it was considering nationalization of a number of other large-scale firms. Prices of staple foods were frozen, but a Revolutionary Council guideline calling for wage controls has not yet been implemented.

In view of the unsettled conditions, Portuguese GNP probably will not rise at all this year and may decline. The jobless rate is likely to reach 10% as more soldiers return, a new group of young people enter the labor force, and jobs for migrant workers in the European Community remain scarce. Private investment will continue to be depressed, particularly in industries threatened with nationalization. The ability of government officials to operate the newly nationalized firms efficiently is a question mark. Potential foreign investors will remain wary despite government assurances.

The trade deficit probably will grow this year, and earnings from tourism and workers' remittances will be down. Lisbon will have to draw further on its reserves, which still amount to some $2 billion ($6 billion if the gold is valued at the current market price). (Confidential)■

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SPAIN: STRESSING GROWTH, ACCEPTING INFLATION

Prime Minister Arias is trying to maintain economic expansion in the face of international recession. He is in trouble: output has risen at a slower pace since last summer, inflation has approached a 20% annual rate, a drop in real wages has spawned strikes and demonstrations, and a big current account deficit has opened up. We expect Arias to continue to stress growth while accepting inflation and a sizable current account deficit.

Recent Developments

The Spanish economy lost momentum in the second half of 1974. The higher cost of oil and other imports drained away huge sums at the very time that tourism was faltering and worker remittances were falling off. A moderately expansionary fiscal package enacted in March 1974 was insufficient to offset the impact of these external forces. Furthermore, consumer demand was eroded by accelerating inflation, and business confidence was undermined by General Franco's illness and uncertainties surrounding the succession.

Spain: Balance of Payments

Million US $

	1971	1972	1973	1974 Estimated
Exports	2,980	3,920	5,340	7,100
Imports (f.o.b.)	4,580	6,240	8,840	14,400
Trade balance	-1,600	-2,320	-3,500	-7,300
Services, net	1,690	2,020	2,650	3,000
Of which:				
Tourism	1,880	2,230	[illegible]	2,800
Transfers, net	770	870	1,400	1,100
Current account balance	860	570	550	-3,200
Long-term capital, net	500	930	760	1,500
Basic balance	1,360	1,500	1,310	-1,700
Errors and omissions	-100	40	30	-100
Short-term capital	....	-50	200	800
Other	180	10	-320	200
Change in reserves	1,440	1,500	1,220	-800

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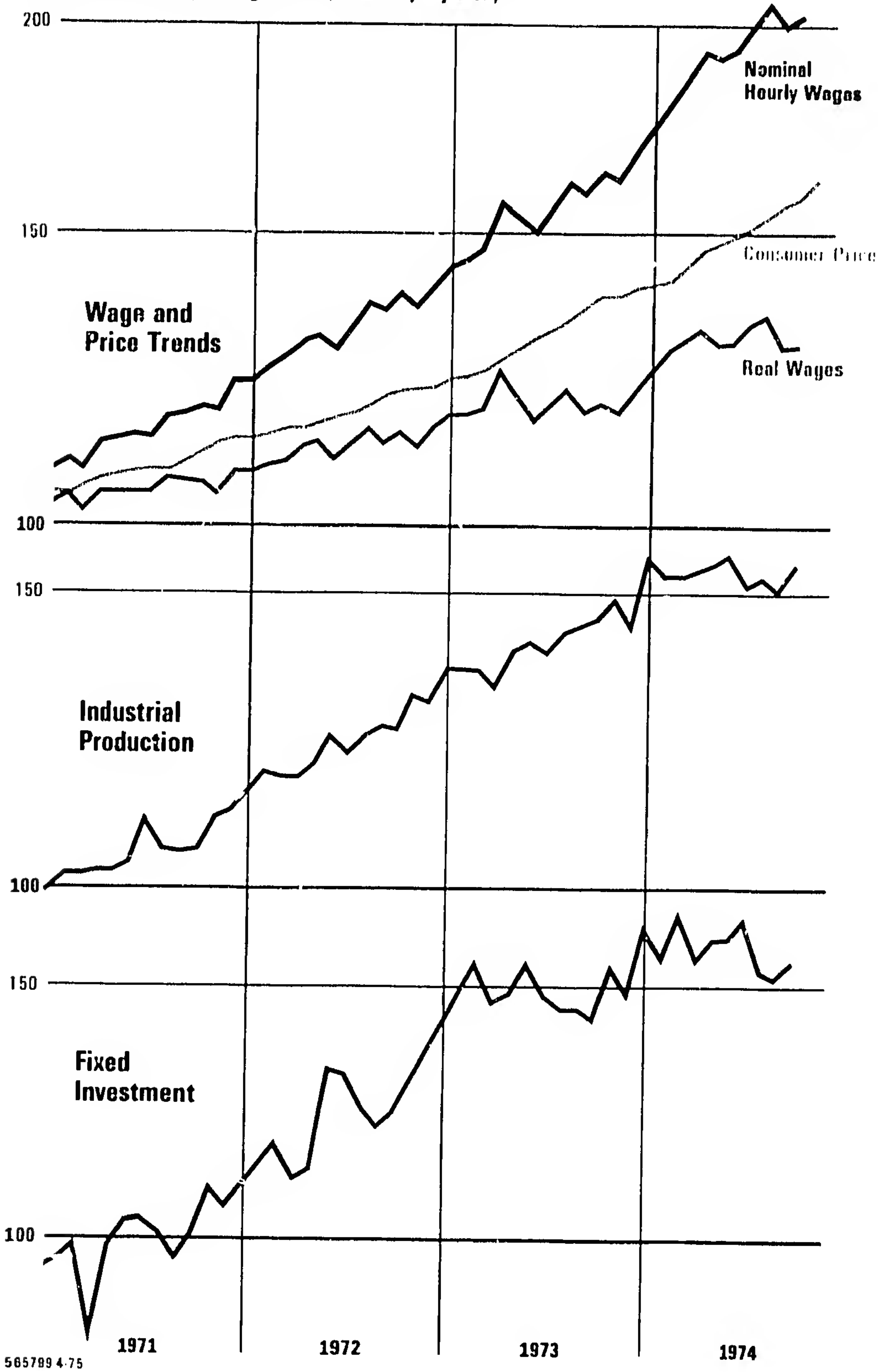
SPAIN: Economic Indicators

Index: 1970 monthly average = 100 (seasonally adjusted)



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Rapid expansion of investment early in 1974 helped keep[1] GNP growth to 5% for the year as a whole. Although this was not too far below the 7% annual average of the preceding decade, by yearend the economy was expanding at an annual rate of only 2%-3%.

As economic growth slowed, unemployment rose -- officially to 1.9% of the labor force in December -- up from 1.2% a year earlier. In reality, unemployment probably was double the admitted rate. Worker unrest, heightened by inflation, increasing job insecurity, and return of workers from abroad has brought a wave of strikes and demonstrations. Although strikes still are illegal, Madrid initially reacted with moderation, reportedly advising employers it would tolerate wage increases as high as 30%. As disorders intensified in January and February, the authorities cracked down.

Consumer prices rose 18% in 1974 – about 4 percentage points more than in the OECD countries as a whole. Prices had begun to soar in the second quarter of 1973. As elsewhere, higher prices on imported oil, foodstuffs, and raw materials were a major influence. Madrid's reluctance to dampen economic activity allowed inflation to go unfettered.

The balance of payments deteriorated throughout 1974. The higher prices paid for oil and other imports were a major factor. Outlays for crude oil jumped $2.3 billion. Drought hurt trade in agricultural products on both the import and export sides. Continued industrial growth in the first half of 1974, combined with domestic inflation, brought a substantial increase in import volume. Declines in tourist receipts and workers' remittances contributed to the $3.2 billion current account deficit. Government-controlled corporations helped protect the country's reserves by borrowing on the Eurocurrency market instead of obtaining funds from the usual domestic sources. Private short-term borrowing abroad drew in additional money. Foreign reserves nevertheless fell by $800 million to about $6 billion.

Outlook

The Arias government will continue to tolerate a big current account deficit and rapid inflation rather than impose austerity measures. We expect real GNP to grow by 2%-3% in 1975, not enough to offset the natural increase in the labor force, the drying up of foreign jobs, and the continuing improvement in labor productivity. Inflation will ebb only slightly and will continue to erode recent wage gains. Further labor unrest seems guaranteed. (Confidential) ■

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TURKEY FACES SLOWDOWN IN GROWTH

Turkey maintained rapid economic growth in much of 1974 despite troubles at home and abroad. The overall growth rate of 7.0%, two percentage points short of plan, ranked among the highest in the LDCs. Performance weakened as the year wore on; further slowdown is likely in 1975 because trade deficits and inflation will inhibit stimulative efforts. The costly Cyprus operation has brought pressure to trim military expenditures. The cutoff in US aid will further complicate the problems of defense budgeting. Ankara will try to protect its economic development program, partially at the expense of its NATO commitments.

Balance-of-Payments Difficulties

The most urgent problem facing Prime Minister Demirel's coalition government is the deteriorating balance of payments. Sparked by rising oil prices, imports jumped in 1974 to \$3.8 billion – 80% above the 1973 level. Export earnings rose by only 15%, to \$1.5 billion, as the result of a small decline in volume. The record trade deficit pushed the current account into the red by \$700 million in spite of continued large remittances from Turks working abroad. A flight of short-term capital apparently contributed to the \$355 million foreign exchange loss in 1974.

Part of the downturn in export volume can be laid indirectly to Ankara's high support prices for agricultural products. Lacking an adequate export subsidy scheme, Turkey attempted without much success to move these commodities at prices above the world level. Cotton sales – normally the top dollar-earner – were further crippled by a worldwide slump in textile output. Rapid domestic inflation and growing world recession reduced the markets for many industrial exports.

Turkish officials are considering import controls and export promotion programs to keep the trade deficit from rising above \$2 billion in 1975. To hold the rise in imports to \$500 million, Ankara proposes to restrict purchases of oil and consumer goods to last year's level. It intends to offer credit incentives to industry in an effort to generate an offsetting rise in export earnings. This goal probably is beyond reach, since Turkey depends heavily on exports of raw materials that will continue to suffer from slack foreign demand.

Ankara can no longer count on worker remittances to cover its trade deficit. The steady decline in the number of Turks employed in West Germany and other European countries will probably push remittances below the \$1.4 billion received in

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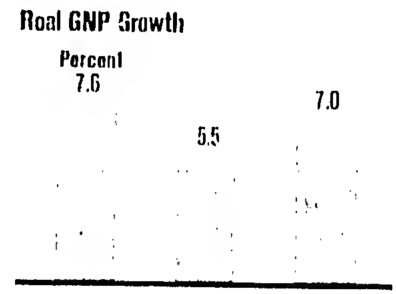
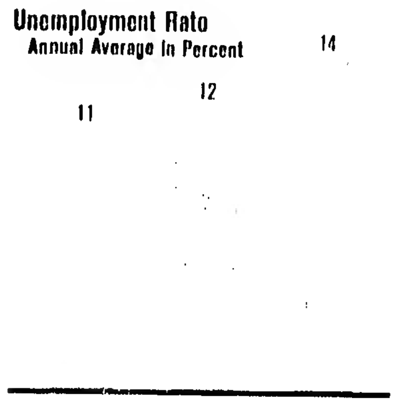
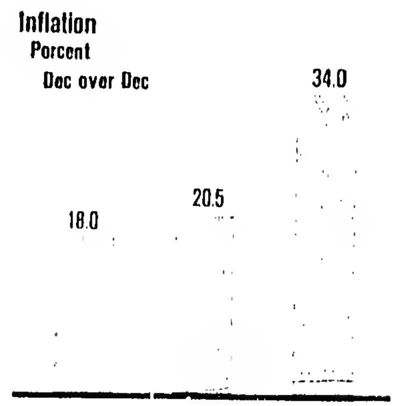
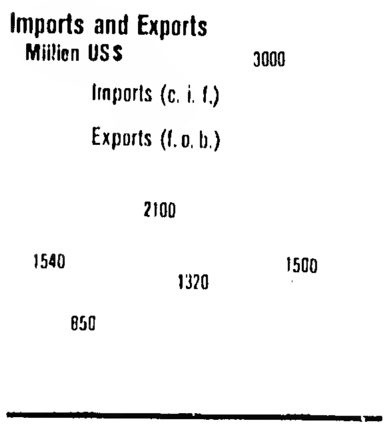
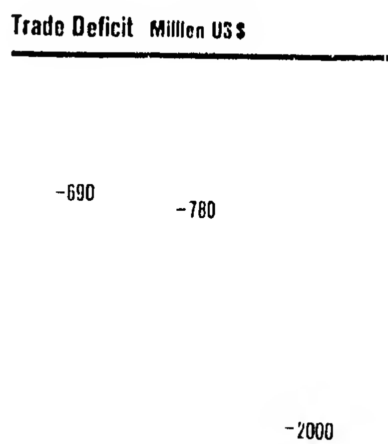
TURKEY: Economic Indicators

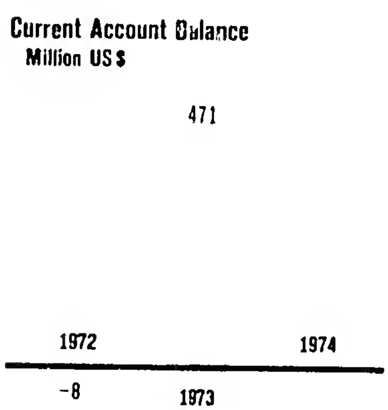


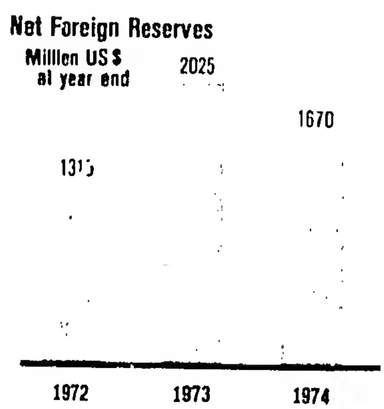












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1974. Government efforts to place returning workers in new jobs in oil producing countries will not compensate for losses in European employment.

Dealing with Inflation

Spiraling inflation is pressuring Ankara to rein in spending, despite the cost in economic growth. The inflation rate has about doubled in the last two years to 34% because of sharp wage hikes, food shortages, and soaring prices for imports, particularly oil. The proposed national budget for the fiscal year beginning in March calls for no increase in outlays in real terms. To boost revenues, Ankara is considering taxes on agricultural income and a progressive income tax system. (Confidential No Foreign Dissem)■

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